Economic Update

MAR
2017

US: FOMC on track to raise rates

Markets focused heavily on policy speeches given in the US this month. The first came with President Donald Trump delivering a more measured, positive and optimistic message for his first Congressional address. Despite being relatively light on detail he reiterated his commitment to a pro-growth policy agenda – of which the key tenets were tax reform centred on corporate and household cuts, deregulation and infrastructure spending. Defence spending and immigration reform were also reaffirmed as key policy priorities, while the President also seemingly softened his language around potential trade barriers, highlighting "fair" trade rather than imposing undue restrictions. The President's more conciliatory tone on policies that potentially pose larger medium term economic risks left markets relatively comfortable. And consequently the rally in equity markets that occurred through February and early March was well supported.

There was also a positive narrative coming from the US Federal Reserve centred on preparing markets for a near term interest rate hike. A chorus of regional Fed governors suggested a near-term rate rise would be appropriate. This came as further progress is made towards the Fed's key economic mandates and global economic conditions remain supportive. On the former, the last three months of payroll data have averaged 187,000 new jobs per month and the unemployment rate has remained below 5%, averaging 4.7%. Whereas inflation, in headline, 'core' and consumption deflator terms, has accelerated to 2.5%yoy, 2.3%yoy and 1.9%yoy, respectively, according to the most recent data.

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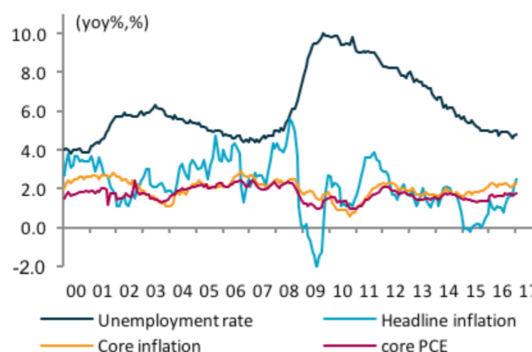
Importantly the chorus of supportive voices included Dallas Fed President Robert Kaplan and Philadelphia Fed President Patrick Harker, both of whom are new Federal Open Market Committee (FOMC) voters in 2017. New York Fed President William Dudley arguably made the most transparent remarks suggesting "the case for monetary policy tightening has become a lot more compelling". And even Fed Governors Lael Brainard and Jerome Powell, who have previously remained relatively dovish, seemed to be supportive of ongoing policy normalisation. US Federal Reserve Chair Janet Yellen echoed her committee members' sentiment. Yellen suggested that outside of any disastrous payroll data preceding the meeting the Fed would evaluate whether employment and inflation were continuing to evolve in line with expectations, "in which case a further adjustment of the federal funds rate would likely be appropriate". Markets and economists broadly agreed her statement was the strongest indication yet rates would be raised at the Fed's March meeting, leaving the central bank on track, as reflected in its "Dot Plot", to increase rates three times this year.

US: Unemployment & inflation

Continued progress with the Fed's mandate



Source: IFM Investors, BLS

Messages from both the White House and the Federal Reserve have for now left markets comfortable with both the notion of "reflation trade" for now and that we are now edging past an inflection point in the global economic and monetary policy cycle. However, the timing of any further fiscal policy stimulus will be important if the current accelerated momentum in the reflation trade is to be maintained. It would therefore be unsurprising if we see a pullback, but not an outright reversal, should policy timing and/or content expectations disappoint.

UK & EU: all quiet for now

The focus on the US economy and political developments has seen those in the UK and Europe fade into the background.

In the UK, growth is as strong as can reasonably be expected at 2.0%yoy in the December quarter – slightly weaker than market expectations, but not materially so. Similarly, the unemployment rate is low at just 4.8% with momentum in the labour market remaining solid. Yet for households the data is starting to show signs of softness. Both retail sales and sentiment deteriorated in early 2017 after a solid showing through much of late 2016. Further, despite PMI (Purchasing Managers' Index) data and business surveys remaining relatively robust, there was a decline in business investment in the December quarter. This corporate caution is expected to persist as we edge towards the triggering of Article 50 and the start of formal Brexit negotiations later this month.

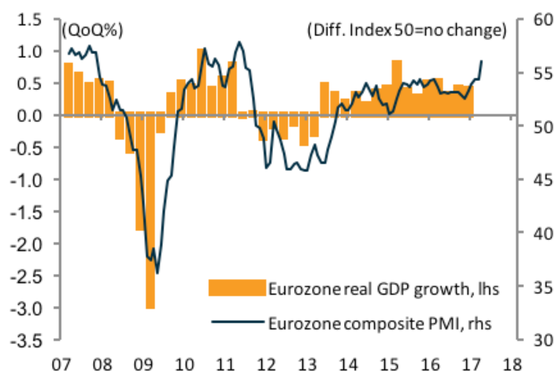
Indeed negotiations between the UK government and the European Union may be strained from the outset. This is as the EU may impose an estimated £50 billion 'exit fee' on the UK, liabilities that it suggests will still be owed to the EU budget. Predictably such a claim has been rejected by a UK House of Lords committee, which presents the risk of an acrimonious start to what will likely be long and drawn out negotiations.

For their part, the Europeans are presenting a united front whilst awaiting the triggering of Article 50. In the meantime the region's economy is tracking along well. The February Composite PMI rose to 56.0, up from 54.4 in January, a 70-month high. This strength reflected good performance in both the manufacturing and services sectors. Further, the largest four European economies, Germany, France, Italy and Spain, all observed solid increases. GDP growth in the December quarter reflected these improving outcomes.

However, with tailwinds from lower oil prices and curtailed fiscal austerity now fading we would be cautious to translate strong ISM manufacturing data outcomes to any further acceleration of growth in the March quarter. This is particularly true as speculation and uncertainty builds ahead of European elections.

Eurozone: Real GDP & Composite PMI

Soft data point to a robust Q1, but uncertainty is building



Source: IFM Investors, Bloomberg, EuroStat

It is also expected that the European Central Bank (ECB) will remain relatively cautious, and even dovish. Its stance comes despite robust growth and the 2% inflation target being met in February for the first time since 2013. However, it should be noted that headline inflation accelerated to 2.0%yoy in February due to arguably transient impacts from food and oil prices. As a result the 'core' measure of inflation remained stable at a more modest 0.9%yoy, and it is expected that the ECB will leave policy and language unchanged in the foreseeable future. The bank will nevertheless likely begin discussing 'tapering' its quantitative easing program later this year, a further sign the inflection point for monetary policy has been passed.

China: growth target slightly lowered

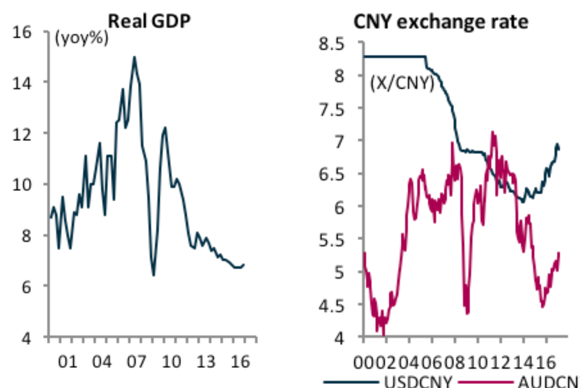
Early March has brought the fifth annual session of China's 12th National People's Congress (NPC), ahead of the quinquennial NPC elections later in the year. Broadly comparable to the Australian Federal Budget address or US State of the Union, the session began with the 2017 Government Work Report (GWR) – a document, delivered by Chinese premier Li Keqiang, reviewing the government's economic and social development plans and budget for the coming year.

Importantly the report outlines various economic targets the government has set for the economy over 2017. These targets were broadly in line with market economist expectations and consistent with President Xi Jinping's recent call that China must "maintain stable economic and social development" ahead of the all-important Party Congress later this year.

The GWR has pledged a GDP growth target of around 6.5%yoy. However the government should "in practice try to achieve a better result". Such a rate of growth would facilitate solid jobs and household income growth, accompanied by an unemployment target of 4.5%. Despite the GDP target being down last year's goal of 6.5-7% growth, there will likely still be some measure of additional policy support required to ensure it is met. However, scope for additional measures remain given the CPI inflation target is unchanged at 3.0%. Last year's rate of inflation averaged 2.0% and is expected to decelerate materially in February's data from 2.5%yoy.

China: Real GDP growth & exchange rates

Growth target sustained and supported by weaker CNY



Source: IFM Investors, Bloomberg

However the focus of policy stimulus will be fiscal rather than monetary, with the latter expected to be relatively neutral through the year. A lower growth target of 12% rather than 13% for money supply, or M2, growth and Total Social Financing underscores the government and central bank's concerns over China's corporate debt levels and medium term financial stability.

While pledging to be "proactive" on fiscal policy, the target for the budget deficit will remain at 3% of GDP. Railway investment will remain at CNY800 billion (A$152 billion) and roads budget will increase 9% to CNY1.8 trillion.

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Another 15 large water conservation projects will begin this year after 21 were started in 2016. Such commitment to infrastructure spending along with policies designed to reduce overcapacity in the steel and coal industries bodes well for Australia's resources exports and commodity prices more broadly. Authorities will also commit to supply-side structural reforms of state-owned enterprises, the property and resources sectors, as well as easing restrictions on foreign investment into China.

On the exchange rate, the authorities will maintain "the direction of making RMB exchange rate further market-driven/liberalized". The pledge likely means there is at least some scope for further CNY depreciation. The AUD/CNY has appreciated 20% since early 2015 and we would be cautious of the appreciation due to the impact it may have on the demand for Australian services, primarily tourism.

Australia: the RBA has nowhere to go

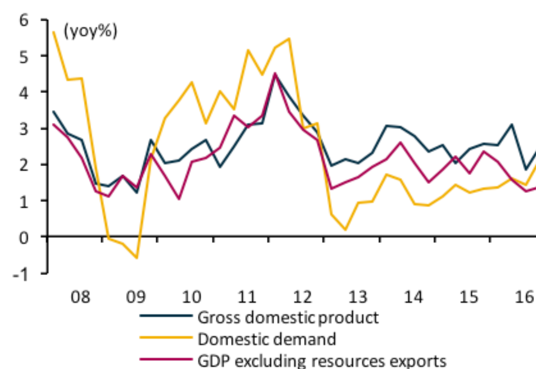
The Australian economy has enjoyed a mixed start to the year, and many of the trends in place in late 2016 remain in the first quarter of 2017. Yet what has become abundantly clear is that the Reserve Bank of Australia (RBA) currently has very little appetite to ease monetary policy any further.

December quarter national accounts data brought news of a rebound in the Australian economy. Real GDP growth came in at a better than expected 1.1%qoq after a 0.5%qoq reversal the previous quarter – and as a result through the year growth accelerated to 2.4%yoy. Nonetheless, looking through the volatility the economy is expanding at a six-monthly rate of just 0.4% - still well below trend and not enough to generate a level of employment growth necessary to keep the unemployment rate stable without a commensurate decline in participation.

The pressures are a result of domestic demand growth remaining tepid at best at 2.1%yoy, well below the 4.2%yoy long-term average, partially driven by the well-known decline in resources investment. But there has also been inconsistent growth elsewhere. Other interesting aspects of the December quarter data included a 1.2%qoq rebound in dwelling investment – despite falling 1.3%qoq in the previous quarter – a modest rebound given the strength of the pipeline; a strong 0.9%qoq outcome for household spending, yet again fuelled by depletion of savings in light of weak income growth; and lastly a strong contribution to growth from public fixed asset investment – government infrastructure spending. As we have said before, this infrastructure cycle needs to gather additional momentum due to the known decline in residential construction coming over the next 12-18 months.

Australia: Real GDP, GDP ex-resources exports, domestic demand

Pickup in domestic demand needs to be sustained



Source: IFM Investors, ABS

For the RBA the figures offered a welcome rebound in growth – particularly true as it has no desire to ease interest rates further. Its reluctance stems firstly from its economic outlook, with growth accelerating and inflation returning to the target band, a scenario not warranting a rate move. Secondly, the bank does not believe the growth and employment dividend (which would likely be small) is worth creating further financial stability and macro-economic risks by encouraging even further the accumulation of household debt.

These are the key themes of the RBA's formal communications and informal ones. Indeed Governor Philip Lowe stated, in the Q&A session of his recent testimony to the Parliament's Standing Committee on Economics, that rates could be cut to "try encourage a bit stronger growth in employment, get the unemployment rate down a bit and get inflation up a bit quickly". But that would risk households being encouraged to "borrow more" despite them already "dealing with the current high levels of debt and slow income growth". Our conclusion is that the hurdle for further easing is a high one.

Market economists are increasingly divided as to the direction and timing of the next move in interest rates. While some are now starting to speculate that rates may rise, we believe it is far too optimistic to suggest this would occur in 2017. This belief largely rests on a positive global outlook and, more importantly, ongoing strong dwelling price growth. What it lacks is a convincing and robust

economic outlook and 'core' inflation comfortably within the RBA's target band.

Our view is that rates will likely need to stay on hold for an extended period. Additionally, the Australian Prudential Regulation Authority should undertake further action to reign in speculative and foreign property market activity. This would cool eastern state dwelling price growth and allow the RBA's monetary policy to be unhindered in supporting the rest of the economy by reducing the pressure for a hike. Unfortunately, from recent experience, this type of co-operation is too much to hope for.

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*as at 31 December 2016

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